MINISTRY: FINANCE
REPUBLIC OF SOUTH AFRICA

INTRODUCTORY SPEECH BY THE MINISTER OF FINANCE

TAXATION LAWS AMENDMENT BILLS, 2011

17 November 2011

Introduction

Mister Speaker, before us today is the Taxation Laws Amendment Bills, 2011. These amendment bills complete the tax legislative process arising from my annual February Budget Speech. Taxes are vital for Government so that it can meet its commitments to our people. Government expenditure, targeted at appropriate programmes, plays a critical role in sustaining economic growth in the midst of an uncertain recovery from the 2008/9 recession.

Fiscal stimulus for the working classes

One fundamental principle of taxation is that members of society should pay tax according to their economic means. Everyone must pay their fair share.

It is with this background in mind that the main feature of the Bills before you is to provide R8.1 million in personal income tax relief for the benefit of ordinary people. As part of this package, most persons can now earn R59 750 a year tax-free. Elderly persons from age 65 to 74 can receive R93 150 tax-free and — those 75 and above can receive R104 261 tax-free. All brackets will be shifted upwards with the top marginal rate of 40 per cent applying only to those persons earning over R580 000.

Other adjustments also exist to stimulate savings. Most persons will now be able to receive interest of R22 800 a year tax-free while elderly persons (from age 65 and over) can receive tax-free interest of R33 000. The annual exclusion for capital gains for all taxpayers is increased to R20 000.

Medical credits

The current provision of tax deductions for medical aid scheme contributions undermines the principles of tax fairness as previously discussed. Wealthier taxpayers effectively receive relief of 40 cents to the Rand for each R1 contributed while many lower income taxpayers receive relief of only 18 cents to the Rand. This result is patently unfair.

In order to remedy this situation, the proposed legislation levels the playing field for all medical aid scheme contributions. Instead of providing deductions, the revised system offers credits. These credits provide relief of 30 cents to the Rand for each R1 contributed, regardless of income level.

Section 45

One of the more notable aspects of the Bills relates to section 45 of the Income Tax Act. This section was only intended to facilitate the movement of assets within a single group of companies without incurring undue tax charges. As is often the case, Government's stated intentions and the ultimate outcomes created by high-end financiers often provide two very different results. History now indicates that section 45 has become a core acquisition tool in the case of leveraged buyouts of target companies. In essence, a leveraged buyout exists when parties purchase a target company with debt.

While we as Government are not opposed to leveraged buyouts per se, at issue is the excessive debt often associated with these transactions. In some cases, the levels of debt amount to 75 to 95 per cent of the total balance sheet of the target company. The net effect of these excessive levels of debt is to generate interest deductions that effectively wipe out taxable company profits for a minimum of 5 to 7 years. Needless to say, these excessive deductions come at an unacceptably high price to the fiscus.

It is this linkage between section 45 and excessive levels of debt that prompted us to take action. Under the final proposal, section 45 will be retained but tightly controlled. More specifically, taxpayers will need to obtain SARS pre-approval before obtaining interest deductions associated with section 45. Excessive debt funding not only undermines the tax system but also raises concerns in terms of systemic economic risk – making companies far too prone to economic downturns).

It should be noted that the tax leakage caused by section 45 and other sophisticated forms of financial engineering are no small matter for our citizens at large. The loss of revenue due to excessive leveraged buyouts is not unique to South Africa – other countries have experienced similar attacks on the fiscus. The consequence of these revenue losses ultimately means that Government cannot pay its debts as they become due. As in the case of Greece and Italy the result has been harsh. Spending cuts have led to job losses, anaemic growth and demonstrations by ordinary citizens. We must remain vigilant and confront sophisticated tax evasion in South Africa.

Larger debt/share debate

Issues arising from section 45 point to a larger set of problems in the tax system – the role of debt versus share financing. Shares are often disguised as debt, and debt is often disguised as shares. This mislabelling of instruments represents a significant risk to the South African tax base as well as for most tax systems internationally.

Therefore, it should be recognised that the debate around section 45 is the beginning of a longer journey. At issue is how to curb these practices while recognising the need for flexible mechanisms to obtain funding – a key but scarce ingredient for generating economic growth. One can accordingly expect further announcements in this area in the years ahead.

Other provisions

These Bills also contain other notable adjustments, including:

- *Small business relief:* Small businesses will be able to use the simplified micro-business turnover tax for gross earnings up to R1 million even if they are registered for VAT. The rates for the turnover tax are also to be reduced by one per cent across-the-board, leaving the maximum rate at 6 per cent. Small business owners who wish to sell their businesses as their main source of retirement will also find that their capital gains will be exempt up to R900 000.

- *Government Islamic Sukuk:* In 2010, several initiatives were introduced to regularise Islamic financing within South Africa. In this round, legislation is now being introduced to add a Government savings instrument that satisfies Islamic principles, known as a Sukuk. This instrument effectively offers a yield that is comparable to a risk-free Government bond. It is hoped that the development of this form of financing could encourage new forms of foreign investment beyond traditional Western funding.

- *Research and development incentive:* Several years ago, Government introduced an incentive to stimulate research and development that effectively allows for a 150 per cent deduction. At issue between taxpayers and SARS is what constitutes "research and development." In order to provide certainty for taxpayers and to protect the fiscus in this regard, it is now proposed that the Department of Science and Technology lead a pre-approval process to provide taxpayer certainty and to prevent other activities from being "dressed-up" as research and development solely for the tax benefit.

- *International headquarter company incentive:* South Africa has many natural advantages as a gateway to the region, such as location, infrastructure, airports and sophisticated financial services. In 2010, we changed the tax and Exchange Control rules to overcome inadvertent barriers that prevent South Africa from utilising these advantages. In the current legislation, we are taking further steps to facilitate this regime based on emerging experience. At this stage, we are engaging with several companies who are seeking to shift their core locations to South Africa based on the revised legislation.

- *Transfer duty relief:* Lastly, it is well known that the real estate sector has been under pressure due to the global recession with many households struggling to find the necessary deposits to acquire a home. The Bills provide relief for these would-be homebuyers by reducing Transfer Duty rates. Home purchases of up to R600 000 are now completely exempt from Transfer Duty (as opposed to the prior R500 000 exemption). Home purchases between R600 000 and R1 million will now also be subject to a 3 per cent charge (as opposed to the prior 5 per cent charge).

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To restate, the tax Bills before you contain a balanced package. On the one hand, these Bills contain many fiscal measures that seek to facilitate growth by alleviating the burden on ordinary working citizens and by removing tax blockages that impede legitimate commercial goals. On the other hand, these Bills also take aim at aggressive tax practices, such as the (mis)use of section 45, that seek to shift large amounts of revenues indirectly from the fiscus for the benefit of a few members of the corporate elite.

In closing, I would like to thank Chairperson Mufamadi of the Standing Committee on Finance as well as the individual members for their constructive role in the process. Their involvement ensures that issues are aired openly and constructively so all voices are heard. These Bills fully reflect those inputs.